

Insurer Properly Rescinded Policy Where Application Did Not Disclose That Employees Were Stealing Money

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The United States District Court for the District of New Jersey, applying New Jersey law, has held that a bankruptcy court properly rescinded an insurance policy where the application denied any knowledge of occurrences that might give rise to claims despite the company's knowledge that employees were stealing money from the company. *In re Tri-State Armored Services, Inc.*, 2007 WL 1196558 (D.N.J. Apr. 23, 2007).

In 1997, an armored car company that serviced ATMs purchased comprehensive employee dishonesty, crime and disappearance insurance as required by its customers. The insurer offered coverage to the company after undertaking a security survey. The insurer renewed the policy annually based on an application similar to the initial application for coverage. The initial and renewal applications included questions regarding the company's loss history. The manager who completed the applications consistently answered "N/A" to the question requesting a list of "[a]ll claims or occurrences that may give rise to claims for the prior five years."

The company was the only named insured on the policy, which stated that it "provides no rights or benefits to any other person or organization." However, the policy included a "Joint Loss Payable" endorsement that named several loss payees who would receive "any loss payable under the Coverage Form" jointly with the company. The endorsement also provided that "[n]o rights or benefits are bestowed on the Loss Payee other than payment of loss as set forth herein."

Throughout the period that the company was insured, it suffered financial losses. The company filed a chapter 7 bankruptcy petition in March 2001, at which time its customer claims exceeded the funds recovered by the trustee by over \$30 million. The company had "borrowed" funds from its wire account and cash vault to pay operating expenses since its incorporation in 1997. In addition, the company repeatedly experienced theft that was not reflected on its books, and company employees used customer funds for personal expenses. The former CEO was the target of a federal investigation for his misappropriations in 2000, although the company's manager later claimed that the investigation did not involve the company but only the former CEO in his individual capacity.

The insurer filed a declaratory judgment action seeking to rescind the policy. Following a 17-day trial, the bankruptcy court rescinded the policy for equitable fraud based on the company's answers on the application regarding its loss history.

The trustee and loss payees all appealed the rescission of the policy and argued that bankruptcy court should not have found reasonable reliance by the insurer on the company's representations. The court rejected numerous arguments against rescission. The trustee and loss payees argued that the insurer was not in a position to rely on the company's representations because (1) it knew of a federal investigation into the company, (2) it knew that another insurer had previously denied coverage, and (3) the insurer had access to the company's financial records. The court held that this evidence was insufficient to establish that the insurer actually knew of the "fraudulent scheme." The court explained that an insurer's investigation did not absolve either the company's obligation to be truthful or the insurer's right to rely on the company's statements. In addition, no evidence showed that the insurer knew the answers to the loss history questions were subjectively false.

The court then rejected the argument that the policy should only be rescinded as to the company and not the loss payees because the loss payees were not insured directly under the policy. It explained that the loss payees did not have a direct contractual relationship with the insurer. Rather, they had rights only to the extent loss was payable to the company.

The court also rejected the argument that defects or negligence in the insurer's underwriting process negated the rescission claim. The court noted that the company had an obligation under New Jersey law to provide complete information on the application, regardless of the insurer's investigation or underwriting procedures. Finally, the court rejected one loss payee's argument that upholding the rescission would detrimentally affect small and regional companies in the armored car industry as unsubstantiated and ignorant of the fact that "the risk of rescission should already be priced into the cost of doing business."